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C O N F I D E N T I A L SECTION 01 OF 04 TEL AVIV 000168

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NEA/FO FOR DANIN, NEA/IPA FOR GOLDBERGER, SHAMPAINE,
ZIMMER, SACHAR, EEB/FO FOR DIBBLE, EEB/IFD FOR GARRY,
TREASURY FOR CONNOLLY, NSC FOR ABRAMS, DORAN

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TAGS: ECON EFIN PGOV PREL IS
SUBJECT: BUDGET PASSES EASILY BUT SPENDING PRESSURE GROWS

Classified By: Ambassador Richard H. Jones for reasons 1.4 b, d.

Summary

¶1. (C) For the first time in years, the Israeli budget was approved prior to the beginning of the budget year, as required by law. The NIS 315.8 billion (USD 84 billion at the current exchange rate of 3.75 NIS to the dollar) Israeli government budget for 2008 passed the Knesset on December 27 by a strong 64 - 32 margin. The budget reflected a substantial reduction in interest payments as the debt to GDP ratio has declined to an estimated 80 - 92 percent from a high of 102 percent in 2003. In addition, the defense budget rose by NIS 2.9 billion (USD 773 million) over 2007 to NIS 51.3 billion (USD 13.7 billion). As per past practice, the Ministry of Finance (MOF) proposed numerous spending cuts as "ammunition" to be negotiated away in return for support from the Labor, Shas, and Pensioners parties, the more "socially oriented" factions of the coalition. Some of the provisions that did not make it into the final budget included a proposed health tax on housewives, a freeze on National Insurance welfare payment increases, and various reductions in other allowances. However, the run-up to the budget vote featured less than the usual amount of horse trading by various economic interests. The main exception to this was a failed attempt by Labor MK (and professional economist) Avishai Braverman to increase expenditures by 2.5 percent for 2008 rather than by the 1.7 percent to which the GOI committed itself under the rubric of the U.S.-Israel Loan Guarantee Agreement. While fiscal responsibility won out in the end, there appears to be growing momentum towards increasing the expenditure ceiling in the future, particularly if the Prime Minister tries to bring the United Torah Judaism party into the coalition. End Summary

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Reduce Rich-Poor Gap

¶2. (C) After four consecutive years of greater than five percent growth in the economy, Israelis are uneasy about the government's seeming inability to narrow the gap between the rich and the poor. While the economic expansion has benefited all sectors, the wealthier sector has benefited the most. The GOI entered the 2008 budget season aware of the public demand to redress this balance by increasing support for the weaker sectors. Consequently, it decided to spend more money on welfare, allowances for the elderly and for Holocaust survivors, health care, and medication. To pay for some of this largesse, the government advocated taxing housewives' health-care benefits, and freezing or reducing

other allowances and National Insurance institutes payments. At the end of the process, the government gave in on some of these issues, canceling the "housewife tax" and most of the proposed spending cuts. It also agreed to spend more on fortifying the town of Sderot - next to Gaza - against rocket attacks. Several Labor MKs, including Amir Peretz who in the past headed the Histadrut Labor Federation and was more recently head of the Labor Party and Defense Minister during the Lebanon War, voted against the budget. Labor Party MK and former Deputy Defense Minister Ephraim Sneh also voted against, saying that the budget did not provide enough funds for defense, especially in light of the threat posed by Iran.

Increase Expenditures - Responsibly

¶3. (C) The major consequence of the public pressure to spend more is a growing consensus across the political and economic spectrum that the annual expenditure increase ceiling must rise beyond its present 1.7 percent. MK Braverman's private member bill to increase the ceiling for the 2008 budget was not adopted, but the widespread sentiment in support of it indicates that an increase in 2009 -- if Israel's economy continues its strong growth -- is all but inevitable. (At one point, opposition leader Bibi Netanyahu, a noted fiscal conservative, confessed to the Ambassador that he feared many in his Likud party were prepared to get on Braverman's bandwagon.)

Expenditure Ceiling on JEDG Agenda

¶4. (C) In a January 17 conversation with EconCouns, Michal Finkelstein, the Senior Adviser to the MOF Director General, said that the MOF had difficulty restraining the desire for higher spending in 2008, and that the expenditure ceiling will definitely have to rise for 2009. She noted that the call by the new Budget Director, Ram Belinkov, to return to a one percent ceiling was "unrealistic," and that the likely number for 2009 will be somewhere between the present 1.7 percent and the 2.5 percent proposed by Braverman. (Note: Belinkov was formerly the DG of the Interior Ministry under Bar-On. He had served in the MOF from 1983-1990, rising to the rank of Deputy Budget Director before leaving for the private sector. Ha'aretz reported on January 2 that he called for a return to a one percent expenditure ceiling. According to the report, he said that moving up to 2.5 percent would harm the credibility of the government and also leave Israel unprepared to deal with the next economic crisis that might arise, for example, as a result of an economic slowdown in the U.S. End Note). Finkelstein added that Finance Minister Bar-On is "a fighter," and is committed to ensuring that Israel maintain its policy of fiscal responsibility. She also referred to Israel's obligations under the 2003 U.S.-Israel Loan Guarantee Agreement as a vital tool to restrain spending and said that her ministry will come to the Joint Economic Development Group (JEDG) meeting currently scheduled for early April in Israel prepared to discuss the possibility of raising the expenditure ceiling in a responsible way.

¶5. (C) In a public lecture on December 26, 2007, Deputy Governor of the Bank of Israel Tsvi Eckstein said that Israel would be able to convince the USG of the need to spend more, but should do so responsibly and not suddenly announce a change without prior consultations (Note: as happened with the increase from one percent to 1.7 percent in 2006, for which the GOI sought retroactive USG approval. End Note). Professor Manuel Trajtenberg, Head of the National Economic Council in the Prime Minister's Office, has publicly stated that it is necessary to devise a formula to change the

expenditure target each year. Dr. Adi Brender of the Bank of Israel's Research Division told Deputy EconCouns in a recent conversation that the one and 1.7 percent ceilings helped the Israeli economy become more balanced. He said that now, however, it is important to "think more long-term" regarding fiscal policy, and that the annual expenditure ceiling need no longer be fixed years into the future.

Budget Passed Easily

¶6. (U) The 2008 budget, which totals NIS 315.8 billion, about USD 84 billion at the current exchange rate of NIS 3.75 to the dollar, passed by a large 64 - 32 margin on December 27, 2007. This was the first time the budget was fully approved before the beginning of the budget year as required by law. Beyond the 1.7 percent expenditure increase over 2007, the 2008 budget includes several one-time expenditures agreed to by the USG resulting from the 2005 Disengagement (NIS 1.1 billion - USD 293 million -- 0.5 percent) and the 2006 Lebanon War (NIS 2.2 billion - USD 586 million -- one percent). Total expenditures for 2008, aside from debt servicing and some small sums invested in infrastructure, will be NIS 235.7 billion (USD 63 billion). The deficit target in the 2008 budget is 1.6 percent of GDP, compared to the 2.9 percent target figure in 2007. (Note: The actual 2007 deficit was 0.02 percent. End Note). The budget was prepared assuming a 4.2 percent growth rate in 2008.

Debt Declines

¶7. (U) Spending is broken down as follows: 31.8 percent for debt servicing; 28.4 percent for transfer payments and support/assistance; 17.8 percent for defense; 17.6 percent for other "civilian needs;" and 4.4 percent for unspecified investments and credits. Civilian spending will increase approximately 6.8 percent, which includes the results of the new public sector wage agreement that was signed with the Histadrut Labor Federation in July 2007, and various other government commitments. Interest payments will decline by approximately 5.3 percent due to the decline in domestic and foreign debt resulting from the responsible fiscal policies followed in the last few years, according to the MOF. The reduced debt is evidenced by the decline in the "debt to GDP

ratio" from 102 percent in 2003 to an estimated 80 to 82 percent in 2007.

Defense Increases

¶8. (U) The defense budget will increase by NIS 2.9 billion (USD 773 million) over 2007 to NIS 51.3 billion (USD 13.7 billion). According to the MOF, this increase is the result of the GOI's adoption of the recommendations of the Brodet Committee, which studied how to address the problems of the defense establishment that were exposed by the Second Lebanon War in 2006. NIS 2.5 billion (USD 666 million) represents the third and final tranche of an NIS 8.2 billion (USD 2.2 billion) Lebanon War supplement distributed between 2006 and ¶2008. (Note: The GOI accepted in principle the Brodet guidelines recommending that the defense budget be increased substantially over the next 10 years and that the defense establishment carry out internal efficiency measures. The Brodet report called for increased spending of a cumulative NIS 100 billion (USD 26.7 billion) between 2008 and 2017, of which NIS 46 billion (USD 12.3 billion) would come from higher budgetary allotments, NIS 30 billion (USD eight billion) from efficiency measures, and the rest from increased U.S. military assistance. End Note)

Turmoil in Education

¶9. (U) The budget of the Education Ministry in 2008 totals NIS 27.6 billion (USD 7.4 billion), with the two largest components being NIS 9.3 billion (USD 2.5 billion) for elementary education and NIS 7.2 billion (USD 1.9 billion) for high school education. The budget also includes NIS 1.16 billion (USD 309 million) to begin implementing education reforms which will cost approximately NIS five billion (USD 1.33 billion) over six years. The reforms will change the teachers' wage structure and work week and provide additional hours for student instruction. The separate budget for higher education totals NIS 6.33 billion (USD 1.69 billion), which does not include money to begin implementing the six year reform plan recommended by the Shochat Education Committee in 2007.

¶10. (U) Education spending has received unusual attention over the past year due to severe labor unrest in the sector. The largest secondary school teachers union struck junior and senior high schools for over two months in the fall of 2007, with the strike ending only after the union agreed to implement reforms in return for a wage hike. Also, university lecturers have been on strike for higher wages since the beginning of the 2007-2008 academic year. So far the Labor Courts have not intervened. Earlier this week, the universities said that the failure to reach a resolution in a few days will result in the complete cancellation of the first semester and may put the entire academic year into question. This threat brought about the desired result as Israel radio news has just begun reporting that the strike has been settled (Friday January 18, 3 pm Israel time).

Comment

¶11. (C) Prime Minister Olmert is facing numerous near-term political challenges which strongly increase the temptation for him to make promises about new spending for 2009 and beyond to strengthen the coalition and the support for him personally. The first is the resignation this week of Minister of Strategic Affairs Avigdor Lieberman and the removal of the eleven Yisrael Beiteinu Party MKs from the coalition, reducing it to 67 MKs out of 120. There are also significant rumblings against the Prime Minister being heard in his own Kadima Party in anticipation of the January 30 release of the final Winograd Report on the Second Lebanon War. Finally, the pressure on Labor Party Leader and Defense Minister Ehud Barak to pull the party out of the coalition when the report is published is ratcheting up. To counter these pressures, the PM has already secured Knesset approval to resurrect the defunct Religious Affairs Ministry, making it very likely that spending beneficial to the religious parties will increase at the expense of other ministries in the short run and at the expense of the budget deficit in the long run. He is also courting United Torah Judaism by

raising the possibility that one of its leaders, Ya'acov Litzman, will return to his former extremely influential post as chairman of the Knesset Finance Committee. The coalition, which only several weeks ago displayed unusual strength in securing the easy and timely passage of the 2008 budget, is now facing a period of political uncertainty. The government's long-standing policy of fiscal responsibility may come under renewed pressure as the Prime Minister maneuvers to navigate the political minefields. End Comment

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